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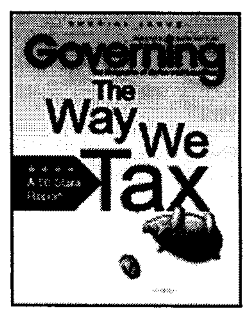
Introduction

THE GOVERNMENT PERFORMANCE PROJECT
The Way We Tax

Star Gazing

A word or two about the rating system

There are scads of pithy proclamations about taxes. One of the earliest came from the Biblical Pharisee who gave thanks that he was "not like other men — robbers, evildoers, adulterers — or even like this tax collector." Then there's Ben Franklin's hoary observation that taxes are as inevitable as death and Oliver Wendell Holmes' noble assertion that "taxes are what we pay for a civilized society." Former IRS Director Mortimer Caplin cynically observed that the only difference between a tax collector and a taxidermist is that "the taxidermist leaves the hide." And, while many of these are witty or provocative, few are more genuinely informative than Russell Long's oft-quoted advice: "Don't tax you. Don't tax me. Tax that fellow behind the tree."



But such Bartlettized comments — while occasionally insightful — don't really shed a whole lot of light on the makings of a good tax structure. And that was precisely what we set out to do in this year's installment of the Government Performance Project: Review the 50 state tax systems. Unlike past years in which the GPP focused exclusively on management in states, counties and cities, this year the effort has been to review both policy and management in one of the most critical areas of state government. The same journalistic team at *Governing* that worked on those earlier efforts took on this new task, aided by a cadre of well-informed advisers.

In assembling this project, there was very little need to reinvent any wheels. In fact, the basic cornerstones of solid tax policy can be found in a well-written 1992 document called "Principles of a High-Quality State Revenue System." It was prepared by the Foundation for State Legislatures and the National Conference of State Legislatures. "It provides a set of criteria, given some differences of wording, that are essentially similar to those done by a lot of groups over time," explains Ron Snell, director of NCSL's economic, fiscal and human resources division. The first iteration was issued by the Council of State Governments in 1939.

The nine principles espoused by this book are (somewhat simplified) that a tax system should:

- have complementary elements, including state and local taxes;
- provide revenue in a reliable manner;
- rely on a balanced variety of revenue sources;
- treat taxpayers equitably;
- facilitate taxpayer compliance;
- promote fair, efficient and effective administration;
- be responsive to interstate and international economic competition;
- minimize its involvement in spending decisions;
- be accountable to taxpayers.

(For more on the principles, see David Brunori's Tax Talk column)

Upon examination, most of these criteria fit neatly into the three categories we've evaluated in this special report: the adequacy of a tax system (including reliable revenues and balanced revenue sources); its fairness (including equitable treatment of taxpayers); and its management (including facilitation of taxpayer compliance and fair administration). Although these three categories do not cover every significant element of a state tax system, they seemed like a rational starting point for considering the most important aspects of their quality.

DUE DILIGENCE

The big question, of course, is how precisely does one attempt to measure these things. It would have made this project significantly easier if there were a standard set of multiple-choice questions that could be asked of the states. But there is clearly no "one-size-fits-all" formula for a state's taxes. It would be simply absurd to anticipate that Alaska, with its wealth of oil, rely on the same sources of revenue as Rhode Island. New Hampshire, which takes pride in providing bare-bones government, simply can't be held to the same standards as Minnesota, with its emphasis on many citizen services.

So, a "scientific" approach in which clearly quantifiable data could be used to compare the states was simply out of the question. Instead, it made far more sense to start with a solid general outline of the elements that contribute to adequacy, fairness and management and then — through interviews and document review — see how successful states had been in establishing them.

In an effort to create that general outline, conversations were held with a number of people with potent reputations in this field. To the extent that there's a solid intellectual underpinning to the information that follows, these individuals are largely responsible. To the extent that the analysis is faulty in any way — and that's probably inevitable, at least occasionally — they're entirely blameless. Two tax experts were especially helpful throughout the process: Harley Duncan, executive director of the Federation of Tax Administrators, and David Brunori, a contributing editor for State Tax Notes who teaches state and local tax law at George Washington University. Our core group of informed advisers also included Don Boyd, director of the fiscal studies program at the Nelson A. Rockefeller Institute of Government; Bill Fox, director of the University of Tennessee Center for Business and Economic Research; John Mikesell, professor of public finance and policy analysis at the University of Indiana; Scott Pattison, director of the National Association of State Budget Officers; Richard Pomp, the Alva P. Loiselle Professor of Law at the University of Connecticut; Andrew Reschovsky, professor of public affairs and applied economics at the University of Wisconsin-Madison; Ron Snell; and Ray Scheppach, executive director of the National Governors' Association.

In addition, a first round of interviews was conducted with the heads of the revenue departments in almost all of the states — or their bosses or designated representatives. These were often used not just to gather information about the individual states but also to refine the methodology for the reporting that was to follow. This included interviews with national and local tax research groups, legislative staff, legislators, budget officers, revenue department staff, academics, state tax task force representatives, members of state bar associations, members of state CPA organizations, private-sector sources and others. In addition, documents that shed further light on the issues of concern were frequently referenced.

There are always hazards to an effort like this one. As Professor Pomp warned, "In the end, people are going to want to use what you've done politically in one way or another. The danger of these kinds of undertakings being misused is great."

DEFINING A STAR

In an effort to mitigate such problems, this project doesn't rely on report-card-type grades, but rather uses a star system to evaluate the states in the areas of adequacy, fairness and management. The definitions of the stars are as follows:

Four Stars: The state is not perfect (none are). But it does very well in the area under consideration and generally has at least one or two elements that make it stand out from the pack in a positive way.

Three Stars: Although there may be room for improvement, the state is essentially performing well. For example, three stars in adequacy may not mean that the state has all the revenues it needs in the current fiscal year. It may mean that the structure of the state is such that in the foreseeable future, the revenue streams will be adequate.

Two Stars: The state could continue to function as it currently does into the foreseeable future. But there are clear elements to the tax system that would benefit from change.

One Star: The area under review needs some kind of dramatic reform; alterations at the margins will not be enough to fix the problems identified.

It's important to note that the written descriptions that accompany these evaluations help explain the reasoning behind the stars awarded. However, they are not all-inclusive. In the near future, more background information pertaining to the rationale for the evaluations will be provided on Governing.com. Moreover, the write-ups are also intended to provide readers with insight into recent events in the state covered, some of which may not have had any direct impact on their star ratings.

Three more points are critical to understanding the evaluations:

• The administration of tax policy — considered in the management category — is not only the province of the revenue departments but of other players in the government as well, including the legislature and citizens who vote for various tax-related ballot measures. Much of the management grade is out of the control of the tax departments, and therefore our stars should not be viewed as solely reflective of their performance.

• Although some would assume that "fairness" is primarily concerned with questions of progressivity in a tax system, we have not drawn distinctions between those that are more or less progressive than others. The benefits or deficiencies of increasingly progressive systems are debatable. However, we have taken into consideration regressivity since there appears to be general agreement that this is not a good thing.

• We do not use any sharply defined set of standards here. However, there were some general questions that were explored in all the states — questions about adequacy, management and fairness — while some were considered in only a handful of states or less. For example, the vagaries of the revenue streams that come from incorporations was of particular importance only in Delaware.

THE QUESTIONS WE RAISED

The broadest areas of inquiry included the following:

Adequacy: Does the state have adequate revenues currently — and for the foreseeable future — to provide reasonable support for the programs the legislature has historically seen fit to fund? Is there a balanced, multi-tax approach that doesn't overly rely on any one tax? Is a state dramatically out of line with like states, inhibiting the state's competitiveness or tax compliance? Is the state experiencing budget shortfalls that can be attributed to a weakness in tax revenues? Can the weakness in revenues be attributed to factors totally out of the control of state leaders?

Are there long-term trends that call into question the ability of the current tax system to deliver sufficient revenues down the road? Are there structural issues that make it particularly difficult to deal with obvious tax problems? If the state appears to be doing well, is this because it has pushed funding responsibility to the local level in a way that creates undue pressures on local taxes and taxpayers or severely interferes with the ability of local governments to carry out their responsibilities?

Management: Does the state have adequate resources and management capacity to optimize voluntary compliance, find and get taxes from those who do not voluntarily comply and do this with optimal efficiency for both the state and its taxpayers? Does the state have adequate analytic ability to understand the implications of its tax decisions and to improve management and policies? How accurate have its revenue estimates and assessments of the impact of tax changes been over time? Does it engage in studies of its tax system and use them to create better policy? Does it have good information and data to facilitate understanding of the tax system?

Is staffing adequate to accomplish the job? Is the quality of human resources for the department endangered by high turnover, lack of training, lack of workforce planning or out-of-line budget cuts? Does the state's information technology support efficient tax administration? Are technology tools up to date? Does technology facilitate tax processing and better audit decisions? Is tax information on the Web informative and easy to navigate?

To what extent has the state engaged in taxpayer education efforts and taken steps to improve customer relations? Do compliance efforts ensure that tax laws are obeyed while taking into consideration the rights of citizens? Is there anything extremely positive or negative about the tax appeals process or about the oversight of local governments in terms of property tax administration? Are there any other unusual factors that should be considered in the evaluation (major scandals or notable innovations, for example)?

Fairness: Are similar taxpayers taxed similarly, and as a result is the broadest possible base being taxed at the lowest possible rates? Is the system overly regressive? How thoroughly does the state tax services? Does the sales tax on goods have a broad base with a minimum of unnecessary exemptions? Do the state's taxes avoid excessive exemptions and deductions that are not means-tested? Is there anything extremely unfair about the state's approach to corporate taxes (either due to gaping loopholes or out-of-line tax credits or incentives)? Is there anything extremely notable the state has done to make its corporate taxes more even-handed and less vulnerable to evasive tax planning? Are there any other unusual factors that should be considered in an evaluation of fairness (a dysfunctional property tax system, for example)?